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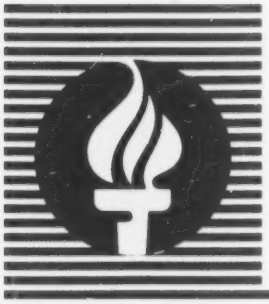

The Conference Board

U.S. Economic Outlook 1987-88

- *moderate 2½-3% growth*
- *"unthreatening" 4-4½% inflation*
- *foreign trade turnaround to offset slack in housing, consumer and defense spending*
- *sustained cut in budget deficit uncertain*

Research Bulletin No. 211

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May 6, 1987

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Chewing Over Old Policy Issues

Edgar R. Fiedler

The spring meeting of The Conference Board's Forum reported a relatively favorable outlook, and it did so with an unsual degree of concordance. The U.S. economy continues to chug upward with a mild case of inflation that, for a while at least, does not threaten to become virulent.

Although minor quibbling was heard about the extent to which this comparatively old business cycle may be tired and infirm, all members of the Forum agreed that the expansion still has a good bit of staying power. They see no recession on the horizon this year or next. The overall pace of advance is projected at a moderate speed.

Several major sectors of the economy are expected to show slower growth over the next eighteen months. The military buildup is being constrained by budget pressures. Housing will be held back by rising interest rates and, on the multi-family side, by high vacancy rates and tax reform. Consumers, although they appear both able and willing to increase their spending as their incomes climb, no longer are in a position to splurge, as they could during the past couple of years, by pulling down their saving rate. Business investment is on a different track, declining last year mostly because of the collapse of oil drilling but also because of the Tax Reform Act. From here on, capital goods outlays are likely to recover, but only gradually.

If these major sectors aren't going to provide much oomph, what will keep the economy moving forward at a respectable pace? The nearly unanimous answer is the turnaround in foreign trade. The international tide is turning, at long last. Since late 1986, a slowing of the growth of imports—coupled with rising exports—has been adding to economic demand in the United States. How big a boost this will produce is unknown, but it represents a striking contrast to the past few years, when foreign trade was a heavy drain on U.S. growth.

These offsetting forces create a modest second wind for the expansion, which thereby remains on the same satisfactory but not boomy growth track it's been following since mid-1984—about 3 percent this year and 2½ percent in 1988, as forecast by the Forum members (see table). What is most remarkable about the projections is their near uniformity. You could throw a blanket over the whole group. To find a dozen forecasters in 1987 projecting the 1988 growth rate within a range of only 2½ percentage points is extraordinary.

The high degree of consensus does not mean, of course, that the outlook is without uncertainty. For example, there's unexpected strength in many reports, from a wide range of industry sources, of surprisingly heavy incoming orders in March and April. Another positive signal was April's sharp drop in unemployment (released just after the Forum meeting). On the other side, the group worried about the recent rise in long-term interest rates, especially its impact on housing. The prevailing judgment, however, is that the rise in interest rates thus far is not enough to choke off the business-cycle expansion. But if rates were to climb another percentage point or two, all bets on a continuing expansion would be off.

Edgar R. Fiedler

Significant deficit reduction could vanish.

Expectations of inflation also show a high degree of consensus. Last year, inflation was temporarily stifled by the collapse of crude-oil prices. With that deflection behind us, the 1987 inflation rate has returned to the 3½-4 percent norm of the past few years. Looking ahead to 1988, in the eyes of Forum members, the continued economic expansion—combined with upward price pressures in the foreign-traded goods sector—will push the inflation rate up to about 4½ percent. Yet there's no sense of any higher rate than that, because there are no upward pressures from the wage side right now.

Policy Accords and Discords

Although most dimensions of the outlook produced uncommon conformance, discussion of policy had quite another tone. The Forum meeting followed close on the heels of Federal Reserve Chairman Volcker's announcement that monetary policy has been "snugged" recently. Within the Forum, some thought this action appropriate; others disapproved. The central difference on this point is the oft-chewed-over question of how close the U.S. economy is to full capacity operations. According to some, the economy is closing in on its capacity contraints, so that it has little room left for further expansion (over and above the painfully gradual advance in the labor force and productivity). If so, then avoidance of a new surge of inflation will require some tightening of policy by the Fed, or at least a less affirmatively accommodative policy than has been pursued through 1986.

As the analysts on this side of the issue view it, the recent run-up in interest rates is much less a result of Federal Reserve "snugging" than a reflection of continued economic advance. Over the past two years, despite what has been repeatedly described as a sluggish economy, total activity has expanded enough to reduce unemployment from over 7 percent to around 6¼ percent. When the rate was near 7 percent, the economy contained some slack, and the trend of interest rates was slightly downward. With unemployment now approaching 6 percent, the slack is gone, and the interest rates are tilting upward. In other words, these analysts see the economy in the process

THE FORUM CONSENSUS
Results of a Pre-Meeting Outlook Survey

		Projected			
	1986	1987		1988	
	Actual	Median	Range	Median	Range
Economic Growth (Real GNP, percent change)	2.0%	2.9%	2.3-3.5%	2.6%	1.0-3.5%
Inflation Rate (GNP Deflator, percent change)	2.1	3.8	3.0-4.5	4.5	3.8-5.0
Corporate Profits (After taxes, percent change)	3.4	12	5-20	9	5-20
Unemployment Rate (Percent, average during fourth quarter)	6.8	6.5	6.0-6.8	6.3	5.7-7.0
Commercial Bank Prime Rate (Percent, average during fourth quarter)	7½	8¼	7½-9	8¾	7½-11
	FY1986	FY1987		FY1988	
Federal Budget Deficit (Billions of dollars)	$221	$187	$180-200	$168	$150-190

Note: These forecasts incorporate submission by Forum participants in early May, and are based on data available at the time. For growth, inflation and profits, the annual forecasts are the percent change over the four quarters of the year, i.e., from 1986IV to 1987IV.

of passing through the "full employment" zone, making the gradual transition from buyers' to sellers' markets. Thus it is time for the Fed to start thinking about congested markets and accelerating inflation.

Those who take the other side of the argument are persuaded that 6¼ percent unemployment remains an appreciable distance from full capacity operations, and that Fed policy, especially as measured by real interest rates, has not been accommodative enough to date. They contend that the modest inflationary pressures now being felt in foreign-traded goods should not be countered by macroeconomic policy. These price pressures arise not from domestic conditions but from the fall in the dollar. When the dollar was rising, especially in 1983-85, the United States enjoyed the resulting disinflationary bonus, while our trading partners had to put up with the corresponding price increases in their economies. Now, with the dollar going the other way, we have to "repay" our trading partners for the disinflation we borrowed from them earlier. Consequently, these current inflationary pressures are unavoidable, except at severely wasteful cost, and the Fed has no business trying to stabilize the exchange value of the dollar by tightening monetary policy. Besides, they argue, the process is only temporary; once the dollar stops falling, the prices pressures will abate shortly.

The other major policy issue considered by the Forum, the "twin deficits" in the Federal budget and foreign trade, is also one that has been chewed over many times in recent years. Actually, this policy question generated quick agreement without lengthy debate; the group simply accepted the proposition that a sustained and substantial reduction in the international deficit—if it is to be achieved without serious repercussions to the domestic economy—will require a sustained and substantial reduction in the budget deficit. There was also a general feeling that a further hefty drop in the exchange value of the dollar would be part of the process.

Even if setting the two deficits right can be accomplished without putting the economy or at least the financial markets through the wringer, the process does have costs. In particular, it will mean that Americans must give up some of the extra gratification we've enjoyed during our consumption binge of recent years. Specifically, we will have to reduce the growth of consumption a percentage point or so below the growth of total output for, say, four years. That may be acceptable as long as GNP advances at a reasonably brisk and steady pace but, if not, the American people may be very irritated and resentful about being required to contrain their personal spending.

To what extent the budget deficit is likely to be cut is not at all clear. Unlike other dimensions of the forecast, estimates of the deficit did not fall within a narrow consensus. The group split into two camps: half looked for the deficit to come down to $150-160 billion in FY1988, while the more pessimistic half saw the deficit holding at $180-190 billion. Neither estimate brings the budget near the Gramm-Rudman-Hollings target of $108 billion for FY1988. How that particular legislation will be buried is uncertain, but there is no doubt Gramm-Rudman-Hollings is dead, at least in its original form.

The Forum's two members from Washington, D.C. provid-

ed reasons for pessimism about the budget. Gail Fosler pointed to the many spending programs for which increased budget authority was being seriously considered, including education, jobs, the homeless, the environment, space, science, child care, Medicaid, AIDS research, law enforcement, election financing reform, drugs and catastrophic health insurance. These spending pressures reflect the lack of consensus on national issues, the polarization between the White House and Congress on budget issues, and a profound disinterest in budget issues generally and in the deficit in particular.

Robert Reischauer reported a different view in part. In terms of public attitudes, he noted, the present is an opportune time to do something about the deficit. Most Americans feel good about their personal economic situation, and they have become more realistic about the steps that must be taken to deal with the deficit. Thus they are ready, albeit reluctantly, to accept the pain of higher taxes.

Politically, however, Reischauer observed that bringing down the deficit has become even more difficult. With the Democrats in control of both House and Senate, budget policy has inevitably become more partisan and contentious. The moderate Senate Republicans are now less likely to search for common ground with the Democrats. And the White House has less reason to mute its criticism, now that budget plans emanating from the Hill do not carry a made-partly-by-Republicans label. Thus the President may finally put into effect the "scorched pen" veto policy he has often threatened in opposition to Congressional budget priorities.

If so, the possibility of significant deficit reduction could vanish in a budget stalemate. With it, we may lose our best hope for a sustained and substantial reduction in the international deficit without bringing on recession or higher inflation or both. Those unhappy repercussions are not likely to appear, in the view of the Forum, until sometime after 1988. But if and when they do, they will be no less unwelcome and no less damaging.

The Cyclical Setting

Richard W. Everett

In this review of the U.S. business cycle I will try to stick to the facts and leave the forecasting to others. The first fact I offer is that the current economic expansion is very old—not just aging but ancient. Through May, 1987, the expansion that began in late 1982 is 4½ years old. Only one purely peacetime expansion period, out of more than two dozen since 1854, lasted longer.

Richard W. Everett

Our economic health has come to depend on the rest of the world.

Age has taken its toll. Each of the major sectors of the private economy made a major contribution to growth at some time in the past 54 months, but the vigor just isn't there any more. Consumers continue to spend money with almost unparalleled enthusiasm, but another jump in their spending would require a greater increase in income than seems in prospect. Special sales promotions that generated automobile sales at annual rates of 16.2 million units last September and 13.6 million units last December are now required to hold sales up to 10 million units. Business investment boomed through 1984, but gains since have been erratic and unimpressive. Housing construction recovered nicely in 1983 and had something of a boom a year ago. Now tax reform and high vacancy rates are restraining apartment building; single-family housing is holding up, but we can't expect much growth there. And budgetary constraints limit increases in public spending.

As things stand, a slow and somewhat halting pace is all we are likely to get out of this old expansion. A substantial reversal in the long deterioration in our trade balance is my only obvious candidate as a rejuvenating influence. In fact, we may need that just to keep going.

I described this as a "peacetime" expansion. That's true, but perhaps a bit misleading. There has been a buildup in military spending that is unprecedented for a period without a war; military spending increased by more than 40 percent in real terms in the five fiscal years after 1981. The buildup is now ending.

My second fact is that economic policy has been extremely expansionary for the past five years or so. When it comes to pump-priming, the New Dealers were a bunch of misers. Federal deficits averaged 3 percent of GNP during the 1930's, when the national unemployment rate averaged 18 percent. For the

past five years, the deficit has averaged 5.2 percent of GNP. The ratio is lower now, but still extremely high. As for monetary policy, I find it hard to assess these days, but it strikes me as having ranged from accommodative to downright permissive through most of the expansion period.

The third and final fact is that our economic health has come to depend on the rest of the world in a degree unmatched since we were a developing nation. We consume more than we produce. We demand far more from government than we are willing to pay for, and we save too little to finance the resulting governmental deficits plus private investment. This was an easy way of life for a while, especially while the U.S. dollar was strong in the foreign-exchange markets. There were adverse effects for some Americans, of course, but the rest of us prospered. But now the United States is the world's greatest debtor, and requires more than $100 billion of new foreign capital to sustain itself. The dollar is cheap, and no longer the barrier to domestic inflation that it once was.

We have made ourselves hostage to the behavior of our creditors. If they tire of financing us on terms that are comfortable to us, the cyclical setting could quickly become recessionary.

Can the Nation's Economic House Be Put in Order for the 1990's?

Robert D. Reischauer

Recent public opinion polls suggest that this would be a good time for policymakers to begin a serious effort to reduce the budget and trade deficits and thus put the nation's economic house in order for the 1990's. The U.S. public is fairly satisfied with current conditions; yet there is concern about the economy and the deficits, as well as a growing awareness that some sacrifice will be required to get the economy back on a more even keel. Whether the nation's political leaders take advantage of this opportunity for meaningful action before it passes remains to be seen.

Robert D. Reischauer

The window for meaningful deficit reduction may be gradually closing.

For the past year, Americans have expressed very high levels of satisfaction with the nation's overall economic situation. This is not surprising considering that the economic indicators most directly affecting the public have improved steadily for at least four years. The national unemployment rate, which peaked at 10.6 percent in December of 1982 has fallen to 6.5 percent; in many East Coast metropolitan areas unemployment is below 4 percent. Helped by the weakening of OPEC, the double digit inflation of 1979 and 1980 slowed to 3.9 percent in 1982 and 1.1. percent in 1986. Nominal mortgage interest rates fell from 15.1 percent in 1982 to 9.3 percent in March 1987, while new auto loan rates dropped from 16.2 to 9.2 percent over the same period. Average personal income tax burdens fell by roughly one-seventh between 1981 and 1986 and will drop further in 1987 and 1988.

Despite the good economic news, the public feels a sense of unease and wonders whether the current situation can be sustained. Taken together, issues relating to the economy—such as unemployment, the deficit and trade—continue to top the list of the national problems that concern Americans.

An overwhelming majority of the public considers the budget deficit to be a very serious problem. While this has been true for several years, there are new indications that Americans are becoming more realistic about the steps that must be taken to solve this problem. Suggestions that the deficit can be eliminated by reducing fraud, waste and abuse in government programs or by pursuing tax evaders in the underground economy have lost their appeal. While the public continues to oppose (by almost a three to one margin) tax increases to reduce the deficit, a majority now feels that the President should reach a deficit reduction compromise with Congress even if this results in a tax increase. A majority also expects its taxes to rise when the deficit is reduced.

While people in the United States may be more willing now than in recent years to accept a serious attempt to reduce the deficit, the political environment makes it increasingly difficult to forge such a plan. With both the Senate and House under Democratic control, budget policy has inevitably become more partisan than it was when moderate Senate Republicans defined the Congressional consensus. Democrats feel compelled to differentiate their budget proposals from the bipartisan plans of the past. Senate Republicans no longer feel responsible for coming up with a budget plan of their own; now they can sit on the sidelines and criticize Democratic propsals to

cut defense spending or raise taxes. The Senate Minority leader, Robert Dole, concerned about his support among conservatives in the 1988 Presidential primaries, could be reluctant to cooperate with the Democrats on any deficit reduction effort that has not been endorsed by the President.

When the Republicans lost control of the Senate, Democrats were stripped of a useful shield that they had relied on to fend off the demands of their traditional constituents. No longer can Democrats argue that increased social spending won't be acceptable to the Senate; no longer can they reason with these interests that a ten percent reduction in some cherished program should be accepted in order to avoid a Senate attempt to cut the program by 25 percent.

The more partisan deficit reduction measures coming out of Congress will be less acceptable to the White House than were past budget bills and the President will feel less obligation to approve them. Past deficit reduction legislation was formulated largely by moderate Senate Republicans, and once the Senate's Republican leadership had put its prestige and muscle behind passage of such legislation, the President's ability to criticize or veto it was constrained. This is no longer the case. The President will no longer rend his own party's Congressional delegation when he accuses Congress of inaction or vetos a reconciliation bill.

Conflict within the Democratic party will prove to be as big an obstacle to meaningful deficit reduction as interparty disputes, for when it come to the specifics of deficit reduction the Democrats will find it extremely difficult to reach agreement. Sharp differences exist within the party with respect to the appropriate level of defense spending and the allocation of defense cuts across weapons systems and other accounts. While a reluctant consensus has emerged around the necessity to raise taxes, there is no agreement about how this might be done. Some favor increased excise taxes on alcohol and cigarettes, but the distributional consequences of such increases are of considerable concern. Moreover, realistic excise-tax increases will not generate the amount of added revenue called for in the Democratic budget resolutions. Others support higher energy taxes but such proposals bring out the sharp regional differences that exist within the party. Energy taxes also would have inflationary consequences that many Democrats want to avoid. Still others advocate an increase in the top marginal income-tax rate or a delay in the tax cuts enacted in 1986; but the President would surely veto any legislation tampering with tax rates.

The window for meaningful deficit reduction may be gradually closing. As the year progresses, increased inflation and higher interest rates could erode the public's sense of confidence and reduce its willingness to accept the painful actions required to reduce the deficit. The political climate could also deteriorate as 1988 approaches and various candidates position themselves for the presidential race. Once the presidential primary season begins, little progress will be made on the deficit until a new President is inaugurated in January, 1989.

Monetary Policy

James Tobin

James Tobin

Further real depreciation of the dollar seems essential.

April of 1987 may prove to have been a critical turning point in U.S. monetary policy, less dramatic than the Federal Reserve's well-publicized moves in October, 1979, and August, 1982, but quite consequential. The Fed, keeping its discount rate unchanged so far, has underplayed its apparent shift to tightness. But the Federal Funds rate, which is under its control, has recently risen about half a point, perhaps more. The prime and long-term interest rates have gone up a full point. The rising difference between yields on long- and short-term securities suggests that the market now has firmer expectations of further tightening of money and credit.

Nothing in the domestic economic picture gives cause for such a shift in policy. Performance and prospects for 1987 look like more of the same stable and sluggish growth the Fed felt comfortable accommodating for three years and, according to its February Monetary Report, this year too. In particular, domestic sources of price acceleration remain quiescent, with money, wage rates, and unit labor costs actually falling in the first quarter. Inflation reports are not as low as in 1986, but we cannot expect to have energy prices fall 20 percent every year.

Evidently the Fed is "defending" the dollar, and for two reasons. One is fear of inflation as higher dollar prices of internationally-traded goods enter U.S. price indexes. The other is fear of the effects of further dollar depreciation on the economies of Japan and Europe. Neither is convincing.

A U.S. current-account deficit of 3½ to 4 percent of GNP is not sustainable. Although the high value of the dollar during 1982-85 is not the only cause of the international deficit, further real depreciation seems essential to its correction and is certainly much more efficacious and acceptable than the protectionism and commercial welfare rising from national frustration with bilateral trade imbalances. Correction cannot occur unless and until foreign goods become more expensive. That will cause some one-shot increases in U.S. price indexes, but in the present circumstances it is unlikely to trigger a continuing price-wage-price spiral. Now is as good a time as we are likely to have, short of full-blown recession, for taking the medicine.

Paul Volcker has said that the contractionary impact of further dollar depreciation on the Japanese and European economies would damage our trade balance more than the depreciation would help it. That the secondary effects would exceed the primary impact is a fallacy—if so, the initial contractions of those other economies would also be reversed! Anyway, Japan and Germany, with negative inflation and near-zero real growth, have plenty of room for dometic fiscal and monetary stimulus, on which we should continue to insist. One way or another, they too will have to learn to live without the present trade imbalance.

Present international interest differentials already allow for significant further dollar depreciation, which the Fed may not be able to prevent except by raising U.S. rates enough to spell recession here. The current-account deficit itself throws a heavy stream of dollars into the markets, and the worries of investors about the future value of the dollar may outweigh short-run interest arbitrage. If tight money adds the United States to the company of depressed advanced democracies, it will also harm other economies, not least the debt-ridden Third World.

The Federal Budget

Gail D. Fosler

In recent months, the notion that the federal deficit is finally declining—even without significant additional policy action—has taken hold. That notion should be reexamined. There is a possibility, even a distinct probability, that the federal deficit will not decline in FY1988. To the contrary, the deficit could actually rise from FY1987 levels.

There are two important realities governing the budget process this year. First, there is no consensus on national direction, reflected by the polarization between the White House and the Congress on budget issues. Second, there is a profound disinterest in budget issues generally and the deficit in particular.

The outlook for the remainder of FY1987 and for FY1988 is for very little in the way of policy change to reduce the budget deficit, with the exception of continued restraint on defense. There is, however, little real willingness actually to cut the defense budget.

Gail D. Fosler

A profound disinterest in the budget.

Significant new spending programs will, however, be authorized (see box). This will place substantial new pressure on appropriations. Indeed, new programs will be in hot competition with the budget deficit for revenue sources as the evolving relationship between the cigarette tax and health-care benefits clearly shows.

In short, if the deficit does go down, it will be macroeconomics in general and inflation in particular that will do the job. My best estimate for the FY1987 deficit is still $175-180 billion. But, for FY1988, the deficit could rise to $180-195 billion. This would leave the budget deficit in the 3.5-4 percent of GNP range until near the end of this economic cycle.

The Budget Outlook: Policy and Politics

The budget for FY1987 is subject to many risks but, even so, it is unlikely that the FY1987 deficit will exceed $185 billion and is more likely to be in the $175-180 billion range. These estimates contrast with estimates of $190 to $200 billion that are common on Wall Street.

The Senate will pass a budget resolution for FY1988 this week. It will call for more than $18.5 billion in new taxes, fund both defense and nondefense discretionary programs at about current policy levels, and contain few spending cuts with the exception of $3.3 billion in Medicare, about $1 to $1.5 billion in agriculture, and $1.2 billion in federal pay and travel. After it goes into conference with the House, the defense level will be reduced, as will be the cuts in Medicare, agriculture and pay.

The extent to which the FY1988 budget process is governed by either politics or policy will be determined later in the reconciliation and appropriations processes. Reconciliation, including tax increases, and any defense appropriations bill are likely to be held in abeyance until the President has signaled that he will sign one in order to obtain passage of the other. The

The Revised Chiles Democratic Budget

Many new spending initiatives that would increase budget authority above a "freeze" are being discussed currently. These include:

- Education programs increase by $2.2 billion, plus an increase for Head Start of $0.2 billion.
- Job programs climb $700 million.
- $400 million in increased assistance to the growing number of homeless individuals and families.
- A $150 million increase for EPA programs and for land acquisition.
- Increases of $1.3 billion for space and science programs, including NASA, the National Science Foundation, and the Department of Energy.
- A $150 million child-care initiative.
- A $200 million Medicaid initiative.
- Increases of $150 million for WIC.
- A $900 million increase for the National Institutes of Health and AIDS research.
- Increases of $400 million for law-enforcement and judiciary programs.
- Increases in Federal grant assistance to state and local governments by about 5 percent annually, compared with the President's increase of less than 1 percent yearly.
- Funding provided for the election financing reform.
- Aggressive new initiatives to combat drugs and extend anti-drug education.
- Funding for catastrophic health insurance.

President, for his part, is likely to attempt to influence the appropriations process to obtain an acceptable defense level while opposing a tax increase. If a new sequester process is in place, the issue will be joined on September 1, 1987, when the President is confronted with the sequester order.

Given the muddled policy outlook and the prospect for confrontation, it is easy to conclude that nothing of substance will be done to reduce the FY1988 budget deficit. On the tax side, the revenue increases in the budget resolution are almost as large as the tax increase enacted in the Tax Equity and Fiscal Responsibility (TEFRA) tax bill in 1982. Even on defense, the final appropriations bill is likely to contain more reprogramming and payment delays but little in the way of real spending cuts.

Without policy action, the FY1988 deficit is currently projected to be $171 billion or just $5 - $10 billion lower than the projected FY1987 deficit. However, there are a number of items that might raise that estimate. First, it is difficult to imagine a set of economic circumstances that would raise nominal GNP in FY1988 relative to current estimates ($4698 billion). Nominal GNP is already running $30 billion or so below the FY1987 estimate. Even better second-quarter growth is not likely to make up for the shortfall in GNP to date. This would lower the overall revenue base in FY1988.

Second, it is entirely possible that tax reform may raise more revenue in FY1987 but less revenue in FY1988. FY1987 was to benefit from both additional capital-gains payments and from the receipts from the retroactive elimination of the investment tax credit. These revenue sources will not be available in FY1988, when it is possible that the revenue loss from the new depreciation rules will be greater than first thought.

The third item is interest rates: While the interest-rate increase is not a significant issue for FY1987, it is extremely important for FY1988. Ninety-day Treasury-bill rates are currently about 20 - 50 basis points above the 5.5 - 5.8 percent rate projected over the next six quarters. Most note and bond rates are 100 - 130 basis points higher. Rates at current levels would add $6 - 7 billion to outlays.

For all these reasons, it is possible that the baseline projection of the FY1988 deficit could rise by $15 to $20 billion—which, at $185 - $190 billion, could put it above the FY1987 level. Under these assumptions, the budget deficit would be mired at about 4 percent of GNP—as the economy begins to head into the late stages of the economic cycle.

The Fiscal Transition

Alan S. Blinder

My assignment is to discuss the broad contours, rather than the nitty-gritty details, of the outlook for fiscal policy. I can summarize my message in five simple statements.

(1) We are, at last, in the early stages of the long-awaited transition to smaller federal budget deficits.

(2) The current deficit reduction path, if maintained for another two or three years beyond fiscal 1988, will bring us to a sensible level of the federal deficit—say $70-$80 billion.

(3) If and when we get there, it should not be that difficult to rebalance exports and imports—say, by 1990 or 1991.

(4) During the adjustment period, however, U.S. domestic demand will have to grow about 1 full percentage point slower than U.S. GNP.

(5) To make this all work, monetary policy will have to take up the slack created by fiscal policy. If monetary policy is tightened prematurely, or if political stalemate once again blocks the fiscal transition, all bets are off.

Alan S. Blinder

Domestic spending will have to grow slower than GNP.

After adjusting the budget to eliminate the distortions of high unemployment and inflation, it becomes clear that, despite all the fuss and bother about controlling it, the deficit grew steadily through 1986, the first Gramm-Rudman-Hollings year. Through fiscal 1985 this was no surprise, as the administration continued its pie-in-the-sky attitudes and belief in puberty economics (you can grow your way out of any problems). Fiscal 1986, however, was a big disappointment, since by then the political consensus for deficit reduction seemed to be in place. The good news, however, is that real progress has been made in fiscal 1987—even if, as I assume, the deficit comes in $17 billion worse than the administration's forecast.

The emerging bipartisan consensus for a deficit reduction of about $36 billion in fiscal 1988, if realized, will be the second straight reduction of roughly that size in the high-

U.S. Saving and Investment

(Billions of dollars, National Income Accounts basis)

	Budget deficit (all governments)	=	*Investment less saving (private sector, domestic)*	+	*Net foreign balance*
1980	– 35		– 41		13
1981	– 30		– 35		11
1982	–111		–110		– 1
1983	–129		– 90		– 34
1984	–102		– 13		– 91
1985	–136		– 26		–115
1986	–142		+ 6		–143
1991 Target I	– 20		– 20		0
1991 Target II	– 20		– 40		20

Note: Excludes statistical discrepancy.

employment, inflation-adjusted deficit. The historical norm for this budget concept for over 20 years prior to Reagan was a deficit of zero. So, we can balance the budget in the economically relevant sense, *if* we continue on this path for another 2-3 years.

If we bear this in mind, the accompanying table shows a particular arrangement of what by now must be everybody's favorite equation relating saving and investment, the budget deficit and the trade deficit. It goes through 1986, which was the worst year for the budget deficit and, we hope, the biggest year for foreign borrowing. What these numbers show is that during 1982 and 1983, we financed the budget deficit by having a weak economy—which generated a large surplus of private savings over investment. But then, as the economy recovered, the savings surplus fell and we had to borrow from abroad.

Now let us speculate about 1987. Suppose the budget deficit drops by $18 billion, and the private-sector saving investment balance returns to its 1985 value. (For that balance to recur, the abnormally low personal savings rate of 1986 will have to change.) Then our net foreign balance should improve by $40-$50 billion. That's an optimistic assessment, compared with other forecasts I've seen.

What about a target for 1991? Suppose we succeed in getting the federal deficit down to $70-80 billion, as suggested above. If the state and local surplus remains around $60 billion, the total government budget deficit is no more than $20 billion. As we look at the table it is clear that a private investment saving balance of only minus $20 billion (Target I) is enough to be consistent with zero foreign borrowing. A more normal investment-saving balance of minus $40 billion (Target II) would be consistent with plus $20 billion in the net foreign balance. Thus, if the fiscal transition works, we can meet our international obligations without another recession.

Making this transition without recession, however, requires cooperation from monetary policy. Recent pledges (and actions) to push up interest rates do not bode well for the future. Furthermore, to swing our trade around by about $150 billion in 1982 dollars, domestic spending in real terms will have to grow about 1 percent per year slower than GNP for about four years. Americans, I'll predict, won't like that. Neither will the next occupant of the White House.

In Europe: Steady as She Goes

Eduard J. Bomhoff

Eduard J. Bomhoff

Big government is unpopular throughout Europe.

Economic growth in the Common Market area has been very stable since 1983. Both in the European community as a whole and in its most important component, West Germany, economic growth has moved within a very narrow range. Forecasts for 1987 are for a continuation of moderate growth at a rate somewhat below the average for 1984-1986, assuming that the negative effect of the appreciation of the EEC currencies is more important than the stimulative monetary policy in Germany and the United Kingdom. Thus economic growth in Europe will not deviate far from 2 percent during 1987. Indicators of consumer cofidence confirm this view. The indicators deteriorated somewhat during the final month of 1986 and in early 1987, but certainly not so extensively that consumers seem to be forecasting a recession. Generally speaking, domestic demand is substituting to a considerable extent for losses in the export markets.

The German central bank will be under tremendous pressure to increase money growth in Germany as we approach the 1988 U.S. Presidential elections, but inflation in Germany seems unlikely to increase beyond 2 to 3 percent. Because economic policy is more volatile in the United States than in West Germany, the dollar-Dmark exchange rate is primarily a function of what happens in the United States. There is no doubt that U.S. authorities are putting enormous pressure on the Bundesbank to inflate, both to promote economic growth in Germany, thus stimulating U.S. exports to Western Europe, and to prevent a further decline in the dollar. Compared with other central banks, the Bundesbank is quite independent and seems unlikely to throw away its reputation as a supplier of low and stable inflation. Thus, I expect the Bundesbank to continue its current stimulative monetary policy, but not to the extent that inflationary expectations in Germany are allowed to rise substantially beyond their current low values. Accordingly, there seems to be no reason to forecast any large changes in German long-term interest rates. Short-term interest rates will always be a function of movements within the European monetary system, but the general tendency has been for the German mark to become stronger after each currency realignment. A reasonable forecast, therefore, would be for slowly declining or at least stable long-term interest rates and no spectacular movements at the short end.

Big government is unpopular throughout Europe, and there seems to be little political pressure for more government spending. The exceptions are training programs for the long-term unemployed or for unemployed young people and investment in infrastructure. True, unemployment remains high by any standard, but public opinion does not seem to believe that either expanding government employment or increasing subsidies to unprofitable firms are appropriate mechanisms for dealing with structural unemployment. Furthermore, European policy makers tend to attach less weight to the effects on economic growth of short-term changes in government expenditure than do their U.S. counterparts. Unemployment is (correctly) regarded as a long-term problem that requires changes in labor market institutions, marginal tax rates, or industrial policies, rather than injections of government funds. The political climate has changed considerably since the late 1970's when a lower level of structural unemployment was attacked in many countries with a combination of subsidies to firms and more direct government outlays. Thus if policy stimulus is to be instituted in Europe, it is more likely to come through planned reductions in tax rates than from higher government expenditure.

Can the U.S. Economy Sustain its Trade and Budget Deficits?

Eric J. Kruger

Are the U.S. budget and trade deficits finally shrinking? Recent evidence suggests that the huge U.S. merchandise trade deficit may have peaked at $170 billion in 1986. The official dollar-denominated trade data do not yet reveal this trend; but measured by volume, exports are r sing and imports are growing more slowly. This trend will continue because import prices are finally showing some increases.

While the low dollar is helping U.S. exports to recover, this does not mean that it will significantly reduce the nominal U.S. trade deficit. Many U.S. exports are not price (and therefore exchange-rate) sensitive. About 50 percent are sold to countries whose currencies have not appreciated against the dollar. Many U.S. exports lack competitiveness for reasons other than price. Similar "non-effects" are visible on the import side, notably consumer price insensitivity and price reductions by foreigners offsetting exchange-rate increases.

Moreover, there has been a moderate increase in real U.S. growth in 1987-88 relative to its major partners increasingly visible in export- and investment-led U.S. expansion. This increase may well lead to an increase in imports relative to exports—especially in consumer products—and a resumption of growth in the U.S. merchandise trade deficit from its trough of $150-160 billion by the end of 1987.

Aside from the weak impact of exchange rates and the strong impact of cyclical forces on the U.S. trade deficit, there are two other, more powerful reasons why the U.S. merchandise trade deficit is unlikely to be reduced. The first is the decline of markets in developing countries with large external debt and in the oil-exporting countries, which absorbed 40 percent of U.S. exports until the 1980's. The second is the structure of the U.S. economy relative to that of its major trading partners. This latter factor is critical in explaining why the trade deficit is likely to be a persistent feature of U.S. economic life. The United States is now predominantly a services-producing economy. It is also affluent and large, consuming more goods than it produces. The huge U.S. trade deficit in goods does not in and of itself present a problem for the national economy (which is not to say that competition from imports does not present individual U.S. manufacturers and their workers with difficulties).

What is at issue here is the capacity of the U.S. to pay for this deficit, whether by goods, services or income inflows. The real problem is the woefully insufficient net U.S. sales of services overseas and net U.S. earnings from overseas investments. These are approaching zero or even negative themselves, and thus are unable to pay for the deficit in goods. In fact, for the first time in recorded history, the U.S. current account deficit in 1987 may exceed the U.S. trade deficit.

The U.S. budget deficit has probably peaked at $200 billion in fiscal 1986. But again, the fact that it has peaked should not lead us to expect that it will decline rapidly and durably. Prospects of continued slow economic growth in 1987-1988 mean that tax revenues will only increase moderately. The 1986 Tax Reform Act, far from being revenue-neutral, may actually lead to lower actual net revenues than would otherwise have occurred. Tax increases appear out of the question until after the next elections.

Eric J. Kruger

The two deficits are likely to be with us for the foreseeable future.

On the expenditure side, Congress and the Administration are unlikely to be able to agree on any further cuts. The recent rise in prices and interest rates will compound the difficulties of containing outlays through at least 1988. One is led to the conclusion that the large U.S. budget deficit will not drop to $135 billion as hoped, but will remain at around $200 billion, leaving it a major feature of the economic landscape for the next few years. A further decline in the U.S. growth rate, not to mention a recession, would of course cause the budget deficit to grow again.

A government can continue to borrow from its own people indefinitely, as long as it does not draw down its long-term growth potential in the process. Similarly, a goods trade deficit can be afforded if other ways are found to pay for it; most households, neighborhoods and cities that specialize in services have huge goods trade deficits, but pay for them through the sale of their services and income from capital. The problem is that the United States is meeting its shortfalls from foreigners. Indeed, the United States is overconsuming both capital and goods from overseas.

The excess of U.S. federal expenditures over revenues, the net borrowings by U.S. business for investment, and the excess of private consumption over domestic production are linked developments. The U.S. current-account deficit is an inevitable result of these excesses. Any long-term significant reduction in this deficit cannot occur without a contraction in the net inflow of foreign capital, which cannot occur without a drop in the budget deficits and a rise in the flow of U.S. savings to finance U.S. investment.

Since, as has been argued, the two deficits are likely to be with us for the foreseeable future, the United States emerges as utterly dependent upon foreigners' willingness to invest in its private sector and lend to its government. In this context,

the nation faces two key problems. First, its attractiveness to foreigners is in danger of being impaired by its growing indebtedness, Consumer, corporate and government debt are all rising in absolute terms, relative to GNP and, in some cases, relative to equity. Second, the scope of its policy instruments is increasingly limited. Fiscal policy is nearly paralyzed because of the budget deficit. The scope for monetary policy is increasingly circumscribed because of low growth, LDC debt and the independence on foreign capital. And the U.S. is approaching the limits of exchange-rate manipulation.

In these constrained circumstances, the low growth rate of the United States raises the key question of how long the country will remain attractive to foreign investors and lenders. A partial answer can be found in recent history: Despite its two massive deficits, the U.S. economy has kept growing, slowly but progressively, in an expansion that bids to become the longest in the post-WWII period. Furthermore, despite these deficits, the United States has managed to remain attractive to foreign capital. The low dollar is seen as impairing this attractiveness for foreign investors, particularly the Japanese, but most of the time there is no place other than the States that can accommodate the scale of Japanese capital. Moreover, foreign direct investment here is currently a global bargain, as reflected in growing net investment flows into the United States.

It is my belief that the United States will be able to sustain its two huge deficits and remain attractive to foreigners, provided its growth rate and rates of return on investment, at home and overseas, are sufficient to pay foreigners net interest and a return on their investments. This issue, much more than the size of the trade deficit or the budget deficit, is where policy and private-sector attention must focus.

Prices, Pay, Profits and Productivity

Geoffrey H. Moore

Cyclical upswings and downswings in the rate of inflation have long been an important factor in U.S. economic experience. Between 1949 and 1980, we had six upswings in inflation that lasted more than a year, each followed by a downswing. The latest downswing began in March 1980, when the rate of increase in the consumer-price index reached 15 percent. It seems to have ended in April 1986, when the rate got down to one half of 1 percent. Since then it has climbed to 3.9 percent as of March 1987. (The growth rates referred to throughout this report are six-month smoothed percent changes at annual rate, based on the ratio of the current month's index to the average index over the preceding twelve months.) I am inclined to classify this as a new cyclical upswing, comparable with the preceding six upswings.

Inflation cycles are not as well know as business cycles, and certainly they are not independent of business cycles. Nevertheless, they do have characteristics of their own, and even have their own leading indicators. So I think it is worthwhile to look at the current situation with regard to the four P's—prices, pay, profits and productivity—in the perspective of previous inflation cycles. This may help answer the question of where we go from here.

The consumer-price inflation rate (see chart) has been tracking the previous average upswing quite closely, but has been rising somewhat faster than the average. Partly, at least, this reflects a recovery from the low levels of gas and oil prices last spring and summer. When energy prices are excluded from the CPI, the March growth rate is 4.3 percent but its rise to that point is less dramatic.

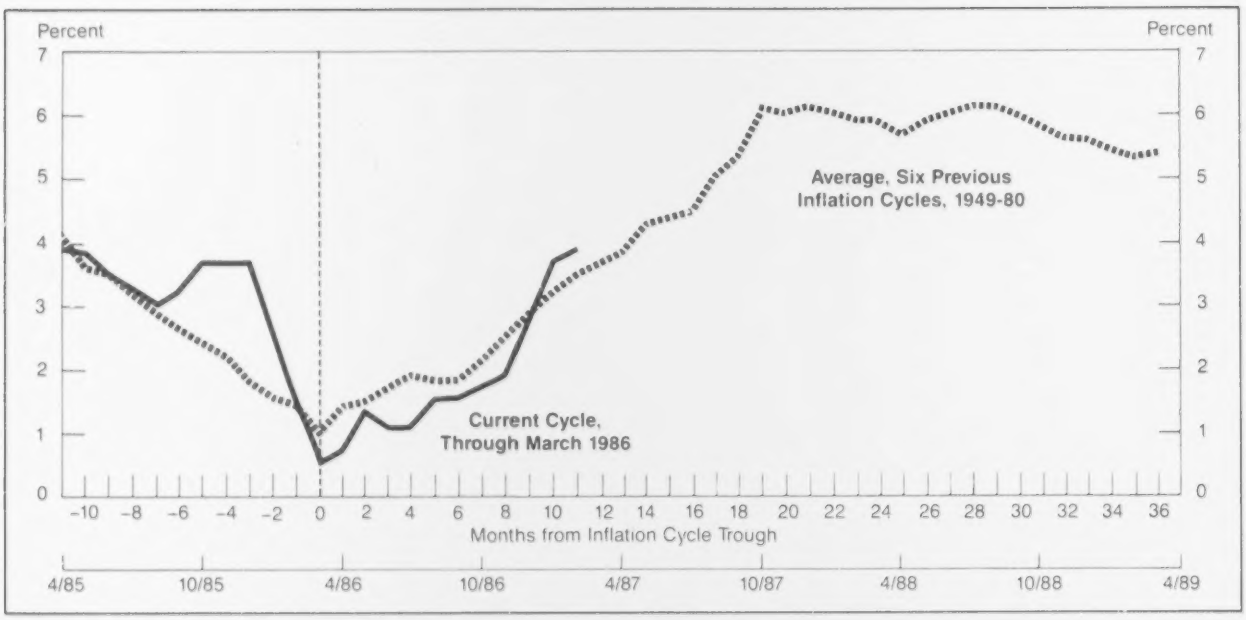
Geoffrey H. Moore

The outlook is moderately upbeat

The producer-price index growth rate started its upswing at the same time as the CPI rate, as it usually does. It rose from a negative rate of -3.9 percent in April 1986 to a positive rate of 2.4 percent in March 1987. The March rate is below the average for the previous six inflation upswings, but the gap is narrowing.

The survey of prices paid by members of the National Association of Purchasing Managers, now available through April, indicates that buyers of materials and supplies for their companies are well aware of the rising inflation rate. The Journal of Commerce daily index of industrial materials prices clearly supports this view. As of May 1st its annualized growth rate was 21.7 percent, higher than at any time since 1979. The acceleration has been widespread among the 18 industrial materials included in the index. As of May 1st the annualized growth rates in the three sub-indexes were: textiles, 15.8 per-

Rate of Change in Consumer Prices
Inflation Cycle Pattern



cent; metals, 8.8 percent; miscellaneous (including crude oil), 33.9 percent.

The leading inflation index calculated by the Center for International Business Cycle Research also has been moving up, starting from its low in September 1985, seven months before the low in the CPI rate. The rise has been more subdued than the six-cycle average pattern, but so far there has been no indication of a reversal.

A considerable portion of this inflationary upswing is due to the decline in the dollar and its impact on import prices. The advance in the growth rate of import prices, excluding fuels, dates from the first quarter of 1985, when the dollar exchange rate began to fall. Since early 1986 import price growth rates in the 7 to 10 percent range have prevailed.

Labor costs per unit of output in nonfarm industries have in the past been a lagging indicator of inflation, with the growth rate in costs beginning to rise some six months or so after the CPI rate turns up. The fourth quarter showed some acceleration in these costs, but this was reversed in the first quarter, so the lagging tendency still prevails.

The modest increases in unit labor costs have been the result of almost equally modest increases in hourly compensation and even smaller increases in productivity. In previous inflation upswings, a speed-up in pay rates has been offset in part, but only in part, by a speed-up in productivity. So far, neither of these trends has appeared.

We come then to the bottom line. Profit margins usually move up in the early stages of an inflation upswing. So does the ratio of price to unit labor cost, which is a proxy for profit margins. That is to say, selling prices advance more rapidly than costs of production. The available quarterly data do not show much evidence that this has happened so far in the current upswing. But we have recently constructed a new monthly price/labor-cost ratio for manufacturing, and this shows that prices have advanced somewhat faster than unit labor costs since March, 1986.

With regard to the future, my view is that the upswing in the inflation cycle will continue at least through 1987, with the Consumer Price Index in the neighborhood of 5 percent by the end of the year. This view is supported by the leading index of inflation, which has been spurred by rapid increases in materials and import prices. Pay increases are likely to react to the more rapid advance in living costs, with 4 and 5 percent adjustments becoming more common. As for productivity growth, my guess is 2 to 3 percent for 1987. Some advance in profit margins is consistent with these figures, especially since I do not regard a recession as imminent. In short, the outlook for prices, pay, profits and productivity is moderately upbeat.

Consumption and Housing

Jason Benderly

Worries persist about the consumer's ability or willingness to keep increasing expenditures. Such concerns are rooted in a variety of considerations, including an historically low saving rate, a debt level regarded by many analysts as too high, and more recently, prospectively anemic income growth and concern that financial-market instability will shake consumer confidence.

A review of the evidence suggests that fears of a major consumer retrenchment are unfounded. The growth rate of real personal consumption expenditures should slow from 4.0 percent in 1986 (fourth quarter to fourth quarter) to a 2.0 percent to 2.5 percent in 1987, a rate more in line with, but still slightly above, underlying income growth.

Jason Benderly

Fears of a major consumer retrenchment are unfounded.

Total real expenditures have declined for two consecutive quarters at a 0.4 percent annual rate, but this does not signal the beginning of a retrenchment. Expenditures, except for autos and trucks, have increased at almost a 3.0 percent annual rate over the past two quarters and, importantly, are still increasing at least at that rate early in the second quarter. An even stronger growth rate emerges if an unusual decline in energy consumption is excluded from consumer expenditures: the growth is real outlays on items other than motor vehicles and energy actually accelerated in the first quarter to a 5.3 percent annual rate from 2.0 percent during the second half of 1986 (see table). The justification for isolating these two components is twofold: First, they are currently subject to transitory influences—the timing of auto financing and sales tax incentives, unusually warm weather during the winter, and a sharp increase in retail energy prices. Second, cutbacks in expenditures on these items have generally not given rise to an offsetting increase in spending on other goods and services.

The conclusion that can be derived from this analysis is that a growth rate somewhere between 3.0 percent and 5.3 percent is a more appropriate gauge of consumer behavior in the first quarter than the 0.4 percent decline in total expenditures. In fact, the notion that underlying consumption picked up in the first quarter is actually more consistent with how consumers typically would react to the $25-billion cut in personal income taxes, which added about 3.3 percentage points to the growth in first-quarter real disposable income. Over the year, in fact, much of the 2 percent income in real income is attributable to tax reform and farm subsidies. An outlook for a continuation of about 2 percent real income growth over the balance of 1987 depends on a slowing of consumer inflation to about a 4 percent annual rate, a 3 percent to 4 percent growth rate of compensation per manhour, and employment growth at a 2 percent to 3 percent rate.

The historically low level of the personal saving rate should not be taken as evidence that consumers will necessarily attempt to rebuild their savings. A significant determinant of

Real Personal Consumption Expenditures

(percent, at annual rates)

		1986		Estimated 1987			
	1983-1986	1st half	2nd half	I	II	III	IV
Total	4.2	4.9	3.1	-0.4	4.5	2.6	1.9
Durables	9.9	5.9	13.5	-17.5	14.0	5.0	0.0
Nondurables	3.1	7.2	-0.5	1.2	3.0	2.5	2.0
Services	3.5	2.9	2.8	4.3	2.0	2.0	2.5
Autos and trucks	11.8	6.0	13.9	-44.8	35.0	10.0	-5.0
Energy	2.6	6.2	8.6	-20.7	5.0	2.5	2.5
All other	4.0	4.7	2.0	5.3	3.0	2.2	2.0

Sources: Bureau of Economic Analysis, Goldman Sachs Economic Research

the personal saving rate has always been household wealth or net worth, and the current 3.5 percent saving rate is in line with aggregate net worth.

The reported stock of consumer installment debt as a percentage of disposable income is terribly misleading as a measure of consumer indebtedness. In general, the ratio of debt to disposable income is determined by five variables:

- the propensity to borrow (defined as the ratio of new loan extensions to disposable income);
- the rate at which loans are prepaid;
- the maturity of those loans;
- the interest rate charged; and
- the growth of income.

Of the five, only the first two can properly be characterized as behavioral in nature. The others may affect behavior by altering propensities to borrow new funds or prepay loans; quite independently of those effects, however, they can influence the debt/income ratio in a purely mechanical way.

A carefully constructed time series of the ratio of debt service to personal income, i.e., the monthly burden of servicing the existing level of installment debt, shows a declining secular trend, in contrast to the rising trend of the debt-to-income ratio. The primary but not sole reason for the divergence is the increasing maturity of most forms of consumer credit.

The newest concern—that increased financial-market instability will lead to a decline in consumer confidence—is difficult to assess quantitatively. As a general rule, if increased instability is going to deter spending, it must first affect some aspect of consumer expectations that bear directly on spending decisions. This would include declining expectations of job opportunities, deteriorating expectations of future personal finances, or expectations of rising interest rates. Unless the volatility in the bond or foreign exchange market causes a deterioration in these expectations, it is not likely that consumer spending will be materially affected. In addition, the rise in interest rates to date is not large enough to cause a significant decline in the path of expenditures.

Housing

The demographics for housing imply an underlying annual demand for about 1.7 million housing units. That figure is derived from the estimated 1.50-1.55 million unit growth in households plus an additional 150,000-200,000 units of demand from several miscellaneous sources. New home sales are currently running in the 650,000-700,000 range, which suggests single family starts of about 1.2-1.3 million units. High vacancy rates and tax reform are taking their toll on the multifamily sector, the result being about a half million unit rate of construction. Total starts are therefore in the 1.7-1.8 million unit range, but only for the time being. A lower level of mortgage rates mostly affects the timing of home sales and starts, not the average level over a full cycle. Starts above 1.7 million are essentially borrowing from the future, and it should thus be expected that starts will decline to somewhat below 1.7 million sometime later this year.

Outlook for Inventories and Capital Spending

Adrian T. Dillon

The role of inventories in the economic outlook has been the subject of some concern and controversy. Reducing the overhang of inventories accumulated in 1984 subtracted 1.2 percentage points from the economy's growth in 1985 and another 0.1 percent from last year's GNP growth. This year is supposed to be a different story: With economic growth continuing at a moderate pace and net exports beginning to turn around, renewed inventory building has been expected to add half a percent to total 1987 GNP growth.

The question is whether that accumulation had already occurred by April. Nonfarm inventory investment reached $27.7 billion in the first quarter of 1987; versus a drop of $9.8 billion in the fourth quarter of 1986. Thus, the change in inventories added $37.5 billion to the first quarter's growth, or virtually all of the 4.3 percent growth rate in real GNP. The concern is that this rapid rise in inventories has been unexpected and excessive, and suggests that from this point forward inventories will be a source of weakness rather than strength in the outlook.

I believe that this interpretation of the inventory situation is incorrect, primarily because all of the buildup in inventories in the past quarter essentially occurred in one industry: autos. Excluding the auto buildup, inventories contributed only 0.2 percentage points to first-quarter growth. In fact, as a ratio to sales, both nondurable and durable goods inventories continued to decline in the first quarter, falling to the lowest levels since the early 1960s.

As we look ahead, the contribution of inventories to the economic expansion during the remainder of 1987 and 1988 should remain moderately positive. This quarter, Detroit's production will essentially equal sales; other nonfarm inventory investment should rise about $25 billion, even assuming a further decline in the inventory-sales ratio. Thus, second quarter real GNP growth is very likely to exceed the consensus estimate of a 1 percent advance. The third quarter could show more modest growth as automakers reduce production significantly below sales, but nonfarm inventories should continue to build at a $20 billion to $30 billion rate well into 1988. In short, except for autos the inventory outlook is bright. In the aggregate, inventories should boost real GNP growth this year by 0.5 percentage points and add another 0.1 point to 1988 economic growth.

Capital Spending

Over the past couple of years, the performance of capital spending has been dominated by tax reform, the surprisingly weak computer sector, and the collapse of oilfield investment. After rising 9.3 percent in 1986, total capital spending fell 1.1 percent last year. Looking ahead, spending should be up a modest 1 percent this year and a relatively strong 6 percent in 1988. Virtually all of this strength will be in equipment rather than structures, however. Perhaps the best news is that, for the first time in the 1980's, U.S. producers of capital goods should participate fully in the strengthening in capital-equipment demand as the trade picture in capital goods begins to turn around.

Adrian T. Dillon

Trade begins to turn.

Last year, total capital *equipment* spending (71 percent of total capital spending) suffered from general concern over the impact of tax reform and, specifically, from the loss of the investment tax credit, which pushed early-1986 spending back into 1985. Real purchases rose 4.2 percent last year compared with the 19 percent rise in 1985. Growth of all major categories of equipment spending slowed last year, with information processing rising 4.3 percent compared with a 13.4 percent advance in 1985. Transportation equipment was up 4.5 percent after a 13.4 percent rise, and industrial equipment purchases were up 4.2 percent last year following 1985's 5.8 percent increase. U.S. manufacturers' shipments of capital goods continued to show more sluggish advances than the trend in purchases, with real growth reaching only 2.4 percent last year as the import share of the U.S. market climbed above 30 percent (versus 12 percent in 1980). To date in the expansion, U.S. purchases of capital equipment have risen 25 percent above their previous cyclical peak; U.S. manufacturers' shipments of capital goods, however, have only in the past 6 months reached the peak levels achieved 7 years earlier. In other words, 100 percent of the peak-to-peak increase in capital-equipment demand during this expansion has gone to imports.

Now, however, the outlook for capital-equipment purchases and shipments is brightening. The negative impact of tax reform is largely behind us, while the positive impact of lower corporate and personal tax rates lies ahead. Information processing equipment, 36 percent of total capital-equipment spending, is finally rebounding from 2 years of very sluggish performance, and should be up at least 10 percent-12 percent annually over the next 2 years. Transportation-equipment spending (22 percent of the total) will be flat this year due to a decline in business purchases of autos, but heavy trucks should be up 10 percent and aircraft up 6 percent. Industrial-equipment purchases (21 percent of equipment purchases) have closely tracked the trend in manufacturing, and should

rebound with a 6 - 9 month lag following the recent improvement in the U.S. industrial sector. After a 2.5 percent increase this year, industrial equipment purchases should jump 6.5 percent in 1988.

For U.S. manufacturers of capital equipment, the prospects are also better. Over the past 9 months, growth of U.S. manufacturers' shipments of capital equipment exceeded the growth of U.S. purchases, as exports jumped at a 15 percent annual rate and imports began to flatten. This year, U.S. shipments should rise nearly 10 percent, beating the forecast (a 5.5 percent rise in total U.S. equipment purchases) for the first time in the 1980's. Next year, U.S. shipments should repeat that performance, rising 11 percent compared with a forecast 8 percent rise in total U.S. capital-equipment spending.

In sharp contrast to the outlook for equipment, the prospects for nonresidential structures (19 percent of capital spending) are poor through 1988. Commercial and office construction was due for a fall because of a 54 percent real increase in building during 1984-1985 that drove vacancy rates to record levels, above 20 percent. Tax reform hurt all sectors of nonresidential construction by essentially halving depreciation allowances compared with prior law for many categories of structures. The 35 percent decline in 1986 oilfield spending also affected this sector of capital spending, producing an 11.6 percent drop in total nonresidential structures spending last year after an 8 percent rise in 1985.

This year, all major categories of nonresidential structures will continue to decline. After last year's 4 percent drop, commercial and office building should fall 17 percent. The decline in industrial structures, which exceeded 15 percent last year, should reach 9.5 percent in 1987. In the aggregate, nonresidential construction is expected to drop 8.3 percent this year. Looking ahead to 1988, commercial and office construction is expected to fall another 4 percent, but we could see a turnaround in industrial construction. Assuming that manufacturing growth continues to pick up over the next year, industrial constuction could rise 5.6 percent in 1988, producing an 0.5 percent rise in total nonresidential construction that year.

Rising Interest Rates in a Challenging Market

Daniel S. Ahearn

The U.S. credit and capital markets are currently struggling with a new and challenging environment. International forces have become much more important. At the same time, the domestic economy and its institutions appear to be behaving differently than they have in the past, so old rules of thumb have become obsolete. And the markets themselves have changed dramatically, reflecting a multitude of financial innovations, rapid changes in the regulatory environment, and a significantly different mix of market participants.

Daniel S. Ahearn

A weakish dollar and a bearish bond market.

Domestically, an extraordinary volume of monetary growth has been recorded in recent years, threatening but not creating—at least not yet—the inflation that historically has resulted from rapid monetary expansion and big budget deficits. The U.S. budget deficit this year will be much smaller than the fiscal '86 record but many see the improvement as nonrecurring and expect continuing large deficits. The record deficit in the U.S. trade account may have peaked in real terms but is probably still rising in dollar terms. And the extent of additional trade improvement in real terms may be limited by consumer preferences in the U.S. and by the sluggish growth of U.S. export markets aboard.

Meanwhile, the U.S. economy continues to rise at a moderate pace, though in recent weeks a substantial acceleration has appeared in the order books of some major industries, which may presage a significant pick-up in the pace of the general economy. Until recently, a large volume of excess capacity and unemployed labor, plus weakness in the international price of oil, had prevented a pick-up in inflation. But the rebound in oil prices and the decline in the dollar are bringing increases both in prices of imports generally and in prices of domestically produced goods competitive with imports, which has revived inflationary psychology. This is a potentially dangerous development, given a background of high monetary growth, large budget deficits, and an emerging drift toward protectionism, which could aggravate such a psychology. As a consequence, Federal Reserve monetary policy has become somewhat less accommodative in the past few months, despite the monetary authorities' concern about the vulnerable international debt situation and domestic credit problems in the agriculture, energy and real estate sectors.

The markets themselves have undergone great changes in

recent years. Investment bankers have created a host of new instruments of which the most widely known perhaps are the mortgage-backed securities, junk bonds, and zero-coupon bonds. Less well known but equally important and not fully understood are interest-rate swaps, which total in the hundreds of billions. Not all the innovations have worked as expected. Many sophisticated investors have discovered that the hedging techniques they adopted to reduce risk have in fact increased it. It has not been uncommon for investors to lose money on both the hedge and the securities they were hedging.

The participants in our credit markets have also changed substantially. Most obvious, perhaps, is the globalization of markets. Events in Toyko have become as or more important as events in New York. U.S. investors often find bond price levels substantially changed from the preceding night's close by the next day's market opening, reflecting trades in London or Tokyo. Foreign investors, notably the Japanese, have been supplying $120 to $140 billion a year to the U.S. credit and capital markets, equivalent to two-thirds of our federal budget deficit. The Japanese have often bought one-third to one-half of new long U.S. Treasury debt issues. This vastly increased dependence on foreign investors appears to have contributed to the volatility of our markets.

Another important change with potential for increased volatility has been the enormous increase in U.S. bond funds. During the past eight years assets held by bond funds rose from $14 billion to $36 billion, or by more than 25 times. Much of the money for this increase came from individuals who were trying to maintain their income as interest rates dropped on money-market funds and similar investments. In effect, these individuals bought into bond funds of longer maturity and lower quality to get a better yield. Anecdotal evidence suggests that many such shareholders are unaware that they are now exposed to capital erosion if interest rates rise or concerns about the quality of assets in junk-bond funds increase. Thus, the risk is rising that increases in interest rates and legal developments in the junk-bond arena might alarm investors and touch off a rash of redemptions. It is too early to say how important this could be but net redemptions of some mortgage-backed securities funds recently rose to 1½ percent of assets per day, similar to what happened to junk-bond funds very briefly last fall. Persisting heavy redemptions in relatively illiquid sectors such as municipals, junk and mortage-backed securities could create a liquidity strain that might invite news media attention and thus feed on itself.

With international investors so important to our markets, the outlook for the foreign-exchange value of the dollar has become a key consideration. The 40 to 50 percent decline in the value of the dollar versus the German mark or Japanese yen has not only offset gains in the bond market for Japanese or German investors but also inflicted painful losses during the past twelve months. No one knows at what level the dollar will stop falling against these currencies. If the bottom is believed near, foreign investors might again buy dollar investments more aggressively, rather than hold back. But even in this case, they are likely to prefer equities, real estate, and direct purchases of U.S. companies, all of which might be expected to benefit from the enhanced competitiveness and relative U.S. production advantage that a low U.S. dollar is providing. The lower dollar provides little incentive for foreign buying of U.S. bonds, which can be expected to suffer from the increased inflation, the acceleration in business and its demands for credit, and the encouragement of a less accommodative monetary policy that a lower dollar fosters. At the same time, the huge buying by the bond funds, a phenomenon of the big drop in interest rates, is not likely to be repeated in an environment of flat or rising rates.

Meanwhile, the lower dollar should enhance U.S. competitiveness and stimulate U.S. industrial production. This will increase demand for inventory and other short-term credit. Demand for long funds should also benefit from a lower dollar as the rising profitability of the U.S. economy increases demand for capital investment.

What can be said about the outlook for prices and yields? First, expect continued high market volatility, violent downswings, and somewhat less sharp rallies. Second, if the dollar is fairly weak on average over some years ahead, the bond market is likely to have a bearish trend, much as it had a bullish trend during the years when the dollar *averaged* on the strong side. Third, interest rates and bond yields are likely to be higher in 1988 than in 1987, if business activity and consumer prices continue to rise as I expect.

Outlook for the Equity Market

Edmund A. Mennis

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A correction now would be far healthier than continued expansion into speculative territory.

The bull market that started in August, 1982, the second longest since World War II, has some remarkable features. From 1982 until the end of 1986, earnings (as measured by the Standard & Poor's 500 stock price index) increased 16 percent. But the price of that index increased 136 percent, so that the market's price-earnings ratio increased from 8.6 to 16.1 times. From the beginning of 1987 to the market peak on April 6, prices rose another 25 percent and the price-earnings ratio increased to 17.8 times a generous estimate of 1987 earnings. What accounted for this performance?

The primary reason, undoubtedly, was the trend of inflation, which moved from double-digit levels in the early 1980's to just over 1 percent last year. Shrinking inflation had a dramatic impact on interest rates; thirty-year Treasuries fell from a yield of more than 13 percent in mid-1982 to about 7.5 percent recently, and three-month Treasury bill rates fell from more than 9 percent to about 5.5 percent. These lower yields forced many investors to seek the higher returns they believed available in the stock market.

Other factors also helped stock prices. Lower inflation improved the quality of earnings by eliminating the distortions due to inventory profits and underdepreciation. The drastic cost-cutting programs and lower labor costs of many corporations improved profit margins and profit prospects. The supply of stocks also shrank, by more than $200 billion in the three years 1984-86. Although private pension funds were net sellers of stocks, public-pension-fund and mutual-fund buying more than made up for this. Moveover, last year and especially in early 1987, foreign investors were major purchasers of U.S. equities.

So much for how we got here. It now appears that some snakes have gotten into our Garden of Eden. No one expected the low inflation rates of 1986 to continue, but a number of forces are pushing inflation up more than many had expected, and inflation is not good for price-earnings ratios. In fact, as the experience of the mid-1970s clearly demonstrates, as inflation rises, price-earnings ratios drop sharply. A major problem is the continuing inability to deal effectively with the federal deficit. In addition, in contrast to 1986, oil prices are trending upward, not falling. The massive U.S. trade deficit has caused a depreciating dollar and higher prices for imports, which in many instances are matched by higher domestic prices as well.

An additional effect of a falling dollar is that it discourages foreign investment in U.S. securities. It requires the Federal Reserve to foster higher interest rates and also to engage in substantial efforts to stabilize the dollar in conjunction with other central banks. Rising interest rates not only provide competition for stocks but also increase the probabilities of an economic downturn that might well expand beyond the United States. In this fifth year of economic expansion, earnings may not rise the 15 percent or more so widely forecast.

Finally, the daily volatility of the stock market has reached a scale not seen before. Investor confidence has been adversely affected by this increasing volatility of security prices, as well as by the insider-trading scandals that have shaken belief in the integrity of the financial markets. Faced with these uncertainties, many investors, foreign and domestic, are having second thoughts, and stock prices are now about 6 percent below their record peaks.

What happens now? The stock market is high by any historical valuation, be it price-earnings ratios, dividend yields or price-to-book ratios. Moreover, some of the factors that sent the market to new highs are beginning to erode. The market seems to have a limited upside potential at this time and, in spite of the recent drop, still seems vulnerable. At current levels, the price-earnings ratio is still 17.4 times a generous estimate of $17 a share earnings, and the dividend estimate of $8.40 provides a yield of only 2.8 percent. With these negative factors, a correction now would be far healthier than continued expansion into speculative territory, with the increasing probability of a more severe drop later.

The dimensions of a correction are hard to guess. They would depend on whether the correction begins soon and occurs gradually. Assuming that we have no unexpected shocks, the dollar stabilizes, the U.S. trade deficit improves, the budget deficit continues its downward trend, and inflation is contained in the 4-5 percent range, the longer term outlook for equities could be quite favorable. We could have another prolonged period of good earnings and relatively high multiples, such as we had from 1958-72. That happy outcome could occur later this year and in 1988. But until a significant reduction occurs in these obstacles to economic and profit growth, I find it difficult to take an optimistic view of the equity market.

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